

Internal Revenue Service
memorandum

date: October 1, 2001

to: Larry Scharf, Team Manager, Reading, PA
-Attn: Revenue Agent Don Palm

from: James C. Fee, Jr.
Associate Area Counsel (LMSB)

POSTF-150577-01
JEBecker, Jr.

subject: Nondocketed Case Advice- Accumulated Earnings Tax

This memorandum responds to your request for advice in connection with your examination of [REDACTED]. This memorandum should not be cited as precedent.

ISSUES

Whether the accumulated earnings tax under I.R.C. Section 531 should be asserted against the taxpayer for the taxable years [REDACTED], [REDACTED], and [REDACTED]?

CONCLUSION

Based solely upon the facts which you presented to us, which included an analysis of the taxpayer's tax returns and financial affairs and computations prepared by the examining agent, it is our opinion that the accumulated earnings tax should be asserted against the taxpayer for the taxable years [REDACTED], [REDACTED], and [REDACTED]. Accordingly, the notice provided for in Section 534(b) should be sent to the taxpayer prior to the issuance of a statutory notice of deficiency.

FACTS

[REDACTED] (sometimes hereafter referred to as "the taxpayer") is a Pennsylvania corporation that was formed in [REDACTED]. Its principal business is the retail sale of [REDACTED] in Pennsylvania and neighboring states. The taxpayer operates [REDACTED] retail [REDACTED] stores in Pennsylvania, [REDACTED] in [REDACTED], [REDACTED] in [REDACTED], [REDACTED] in [REDACTED], and [REDACTED] in [REDACTED]. It owns approximately [REDACTED] of its stores and leases the rest. The taxpayer also operates [REDACTED], a [REDACTED] and [REDACTED]. It also operates [REDACTED], a [REDACTED]

store chain, which has [redacted] stores in [redacted] in [redacted] in [redacted] in [redacted], in [redacted], in [redacted], in [redacted], in [redacted], in [redacted], and in [redacted]. The taxpayer leases all of the [redacted] stores. [redacted] owns all of the trade fixtures and equipment in its stores and several [redacted], which are available for further [redacted]. The taxpayer has its own distribution center and warehouses in [redacted] area towns near its corporate headquarters. It also operates an [redacted] plant, a [redacted] plant, and a [redacted] plant. The taxpayer has approximately [redacted] employees.

[redacted] was originated by [redacted] [redacted] and [redacted]. They were equal shareholders in the closely held company. They ran the business together for many years with [redacted] holding the dominant position. After [redacted]'s death, [redacted] became the CEO. Over the years several trusts and estates have held the taxpayer's stock. At present, [redacted] owns or controls about [redacted]% of the stock. Although he is almost [redacted], [redacted] is still very active in the business. [redacted]'s widow, [redacted], who until recently (see below) also owned or controlled [redacted]% of the stock, was strictly an investor and took no active part in the business. The remaining [redacted] of the [redacted] stock is now publicly traded on the market.

[redacted]'s management of the taxpayer, as might be expected, is very conservative. The taxpayer is self-insured. It also has continuing plans for adding new stores. The capital budget for [redacted] estimated that \$[redacted] would be needed for this purpose within the next [redacted] months. The taxpayer has significant liquid assets, no debt financing, and has historically displayed an ability to generate working capital internally to fund growth. At [redacted]'s direction, for many years the taxpayer has made substantial investments in tax free municipal bonds and United States Treasury notes.

[redacted] is, percentage-wise, the [redacted]. Its CFO informed the revenue agent that [redacted] which makes the difference. The following schedules set forth the dividends paid, the current earnings and profits retained, and the unappropriated retained earnings for the years [redacted], [redacted], [redacted], and [redacted].

Dividends Paid

	\$

Current Earnings & Profits Retained

	\$

Unappropriated Retained Earnings

	\$

In approximately [REDACTED], [REDACTED] informed [REDACTED] that both she and the other shareholders (trusts, etc.) not controlled by [REDACTED] or not public owners of the taxpayer wanted to have the value of their shares enhanced by the company. [REDACTED]

[REDACTED] believed that the stock was worth \$ [REDACTED] per share. [REDACTED], who was very unhappy at this development, offered to redeem her shares for \$ [REDACTED] per share. [REDACTED] rejected his offer. [REDACTED] reluctantly agreed to have the company offered for sale to see what it was worth. The bids that came in were in the upper \$ [REDACTED]'s per share. At this point, [REDACTED] asked [REDACTED] if her shares could be redeemed for \$ [REDACTED] per share, but he informed her that his prior offer had been withdrawn. [REDACTED]

[REDACTED] For her [REDACTED] shares, [REDACTED] received \$ [REDACTED] in [REDACTED]. The taxpayer paid that amount from bonds which it cashed in and from a \$ [REDACTED] loan, which it paid off within [REDACTED] year.

The examining agent prepared the following computations of excess working capital and excess accumulation of earnings and profits:

Cost of materials (Inc. 263A items)	\$	\$	\$
Average of beginning and ending inventory			
Inventory turnover percentage	%	%	%
Months per inventory turnover			
Sales			
Average of beginning and ending accounts receivable			
Percentage of year sales uncollected	%	%	%
Average number of months sales uncollected			
Cost of sales	\$	\$	\$
Expenses			
Estimated Federal tax payments			
Total	\$	\$	\$
Less:			
Depreciation			
Annual operating expenses	\$	\$	\$
Operating cycle percentage	%	%	%
Ordinary operating expenses per cycle	\$	\$	\$
Working capital needs	\$	\$	\$

Working Capital

Current Assets:

Cash	\$		\$		\$	
Gov't. Securities						
Other current assets						
Accounts receivable						
Current notes receivable						
Other assets						
Other investments						
Inventory						
Total current assets	\$		\$		\$	

Current Liabilities:

Accounts payable	\$		\$		\$	
Other current liabilities						
Total current liabilities	\$		\$		\$	

Net working capital	\$		\$		\$	
Working capital needs						
Excess working capital	\$		\$		\$	

To determine the total excess accumulations for each of the years at issue, the agent made further adjustments, as set forth below. The adjustments for Insurance reserve and Legal reserve are estimates since no information was available as to these potential expenses.

Excess working capital	\$	\$	\$
Purchase of marketable securities			
Capital budget from financial statements	(((
Treasury stock purchases	(((
Planned treasury stock purchase	-	-	(
Insurance reserve	(((
Legal reserve	(((
Excess accumulation	\$	\$	\$

You asked for our advice as to whether the accumulated earnings tax should be asserted in the amounts set forth below:

Taxable income	\$	\$	\$
Plus:			
Dividends received by corporations			
Total	\$	\$	\$
Less:			
Federal income taxes paid			
Taxable income as adjusted	\$	\$	\$
Less:			
Dividends paid			
Current earnings and profits retained	\$	\$	\$
Less:			
Accumulated earnings credit			
Accumulated taxable income	\$	\$	\$
Tax rate			
Accumulated earnings tax	\$	\$	\$

DISCUSSION

The accumulated earnings tax was designed to prevent stockholders in corporations from avoiding individual income taxes by having such corporations retain all or a part of their earnings and profits instead of declaring and paying dividends in amounts that exceed the amounts to be used for the reasonable needs of the business. As long as there is a reasonable anticipation of business needs, the tax will not apply. However, the anticipation must be realistic as well as reasonable. Reasonable business needs include debt retirement, business expansion, and plant replacement. Amounts in excess of reasonable business needs are carefully examined to determine whether they were accumulated with a tax avoidance intent. If that intent was present, even if it was not the dominant motive for the accumulation, the tax will apply.

Section 531 imposes the tax. Section 532(a) provides that the tax shall apply to every corporation, with some exceptions set forth in Section 532(b), "... formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed." Section 533(a) states the presumption that the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders. However, this presumption is rebuttable should the corporation prove the contrary by a preponderance of the evidence. Section 534 imposes the burden of proof in the Tax Court on the Government, and provides a notice procedure whereby the taxpayer is given an opportunity to specify the grounds on which it intends to rely to establish that all or part of the alleged unreasonable accumulation of earnings and profits was reasonable for the needs of its business. Accumulated taxable income is defined in Section 535(a) as taxable income with adjustments specified in Section 535(b) less the dividends paid and the accumulated earnings credit under Section 535(c). The accumulated earnings credit is not less than the amount by which \$250,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year. Section 537 states that the reasonable needs of the business include the reasonably anticipated needs of the business and certain redemptions of its stock.

In preparing an accumulated earnings tax case, the Government must of necessity pass judgment on a great variety of business decisions made by the taxpayer that caused it not to pay out its current earnings and profits as dividends. A careful determination must be made as to just what the reasonable needs of the business are for each year. Treasury Regulation §1.537-1 tells us that an accumulation of the earnings and profits, including the undistributed earnings and profits of prior years, is in excess of the reasonable needs of the business if it exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonable anticipated future needs of the business. The need to retain earnings and profits must be directly connected with the needs of the corporation itself and must be for bona fide business purposes. The extent to which earnings and profits have been distributed by the corporation may be taken into account in determining whether or not retained earnings and profits exceed the reasonable needs of the business. Consideration must also be given to reasonable anticipated needs as they exist on the basis of the facts at the close of the taxable year.

The Tax Court has developed certain guidelines as to what business needs are reasonable. In general, there must be enough liquid assets to pay all current liabilities and any anticipated extraordinary expenses and to operate the business for one operating cycle. Accumulations can be made for estimated expenditures with later adjustments for actual costs allowed. Finally, the stated business purpose for the accumulation must be carried out.

Treasury Regulation §1.537-2 lists some reasons which are acceptable for accumulating earnings and profits. These are debt retirement, business expansion and plant replacement, acquisition of another business by purchase of stock or assets, working capital, investments or loans to suppliers or customers necessary to maintain the corporation's business, and reasonably anticipated product liability losses. The same regulation sets forth some grounds which do not justify the accumulation of earnings and profits. These are loans to shareholders and expenditures for their personal benefit, loans to others which have no reasonable connection to the business, loans to a related corporation, investments that are not related to the business, and any accumulations to provide for unrealistic hazards. Some business contingencies which seem likely to occur have been viewed as justifying an accumulation of income. Some of these contingencies are loss of customers and need to move the business, liability for litigation or threatened litigation,

liability for a contractual obligation, self-insurance, keeping abreast of competition, product liability claims, strikes, war, and a deterioration of the particular industry. An accumulation of funds to finance an anticipated stock redemption can be a reasonable business need if the redemption serves a corporate purpose rather than the individual purpose of the stockholders. This is sometimes difficult to determine where closely held corporations are involved.

The first step in an accumulated earnings tax analysis is the estimation of the amount of the necessary working capital of the corporation. A formula developed in Bardahl Manufacturing Corporation v. Commissioner, T.C. Memo. 1965-200 shows how to calculate the amount of working capital needed for the normal expenses of one operating cycle plus any anticipated extraordinary expenses. The formula provides for the following:

1. The corporation's average inventory for the year is divided by its cost of goods sold and multiplied by 365 in order to determine the number of days necessary to turn over the inventory.
2. The corporation's average balance of accounts receivable for the year are divided by the corporation's sales and multiplied by 365 to obtain the number of days necessary to collect accounts receivable.
3. The amounts in 1 and 2 are added together to obtain the total number of days in the operating cycle.
4. The amount of working capital reserve that is needed for one operating cycle is determined by multiplying the amount of the corporation's cost of goods sold plus its operating expenses (including Federal estimated income tax payments) for one year (excluding depreciation) by a fraction with the number of days in the operating cycle as the numerator and 365 as the denominator.
5. The figure determined in 4 above is the amount of liquid assets necessary to meet the ordinary operating expenses for one cycle.
6. The figure determined in 4 above is added to the amount needed to meet specific and definite plans for expansion and any amounts needed for anticipated extraordinary business expenses.

7. The corporation's working capital (the excess of current assets over current liabilities) is compared to the amount in 6 above.

If the working capital exceeds the amount to be retained for the reasonable needs of the business as computed in 6 above, the excess is treated as an unreasonable accumulation subject to the accumulated earnings tax.

In the instant case, the agent's application of the Bardahl formula used months instead of days to plot the operating cycle. However, the results are the same and show that the accumulations for each of the years in question went far beyond the reasonable needs of the business for working capital or beyond its reasonably anticipated needs. The huge retained surpluses from earlier years were easily sufficient to cover the taxpayer's working capital and other needs, including expansion and self-insurance, for the years [REDACTED], [REDACTED], and [REDACTED].

/s/ [REDACTED]

(b)(7)a

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Accordingly, it is our opinion that the accumulated earnings tax should be imposed for each of the years [REDACTED], [REDACTED], and [REDACTED].

CASE DEVELOPMENT

, (b)(5)(AC), (b)(7)a

, (b)(5)(AC), (b)(7)a

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions concerning this memorandum, please call Attorney John E. Becker, Jr. at 215-597-3442.

Our advice is subject to the Office of Chief Counsel's ten day post-review procedures. If the Office of Chief Counsel alters or revises our advice they will contact us within ten working days from their receipt of our advice.

JAMES C. FEE, JR.
Associate Area Counsel (LMSB)

cc: Senior Legal Counsel (HQ) Harve M. Lewis
Associate Area Counsel (PFTG) Michael P. Corrado